

Internal Revenue Service

District Director

Department of the Treasury

P.O. Box 2508  
Cincinnati, OH 45201

Person to Contact:

Telephone Number

Refer Reply to:  
EP/EO

Employer Identification Number:

Date: AUG 23 1994

Dear Sir or Madam:

We have considered your application for recognition of exemption from Federal income tax under the provisions of section 501(c)(3) of the Internal Revenue Code of 1986 and its applicable Income Tax Regulations. Based on the available information, we have determined that you do not qualify for the reasons set forth on Enclosure I.

Consideration was given to whether you qualify for exemption under other subsections of section 501(c) of the Code and we have concluded that you do not.

As your organization has not established exemption from Federal income tax, it will be necessary for you to file an annual income tax return on Form 1120 since you are a corporation. Contributions to you are not deductible under section 170 of the Code.

If you are in agreement with our proposed denial, please sign and return one copy of the enclosed Form 6018, Consent to Proposed Adverse Action.

You have the right to protest this proposed determination if you believe that it is incorrect. To protest, you should submit a written appeal giving the facts, law and other information to support your position as explained in the enclosed Publication 892, "Exempt Organizations Appeal Procedures for Unagreed Issues". The appeal must be submitted within 30 days from the date of this letter and must be signed by one of your principal officers. You may request a hearing with a member of the Office of the Regional Director of Appeals when you file your appeal. If a hearing is requested, you will be contacted to arrange a date for it. The hearing may be held at the Regional Office, or, if you request, at any mutually convenient District Office. If you are to be represented by someone who is not one of your principal officers, he or she must file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements as set forth in Section 601.502 of the Statement of Procedural Rules. See Treasury Department Circular No. 230.

[REDACTED]  
[REDACTED]

If you do not protest this proposed determination in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Internal Revenue code provides in part that:

A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within the time specified, this will become our final determination. In that event, appropriate State officials will be notified of this action in accordance with the provisions of section 6104(c) of the Code.

Sincerely yours,

[REDACTED]

District Director

Enclosures: 3

## ENCLOSURE I

### Facts

Information submitted with your application indicates that you were incorporated on [REDACTED] under the laws of the state of [REDACTED]. The Articles of Incorporation do not contain any guidelines governing how you conduct your internal affairs. You do not have any Bylaws.

Your stated purpose is to provide financial assistance to gifted high school students so that they can participate in educational programs on a national and international scale. The financial assistance is intended to defray program cost and travel and lodging associated with these programs. Selection of recipients is based on the recommendation of public schools in the area and need of the students.

Your financial support will come from donations from the general public and proceeds from your operations. Operations involve buying excess merchandise from various businesses at bargain prices and selling those merchandise to other organizations or individuals via public auctions by an outside broker. The merchandise will include depreciated assets such as surplus computers officer furniture, restaurant equipment, vehicles, and various consumer goods. [REDACTED], the founder and president of the organization, will oversee the buying and selling of merchandise.

The broker will be [REDACTED], a for profit auction/liquidation organization ("[REDACTED]"). [REDACTED] is the owner and president of [REDACTED]. According to information in the application, you will pay [REDACTED] a commission of [REDACTED]% of the gross revenues generated by the auctions. Any advertising to promote the auctions is paid by you. Advertising is limited to \$[REDACTED] per sale. About [REDACTED] percent of your total time will be spent on this activity (buying and selling of merchandise).

The operations of selling and buying will take place at a property located on [REDACTED]. It is a [REDACTED] square foot two-story building, with storage space on the lower level and storage space and offices on the upper level. The funds to purchase this property was donated by [REDACTED]. The purchase price of the property was \$[REDACTED].

The remainder of your total time ([REDACTED] %) will be spent on reviewing applications for financial assistance. Availability of assistance will be made public through direct mail to local school administrators. According to the application, [REDACTED] students will be eligible, and [REDACTED] grants will be made to finalists.

Selection of recipients will be done by a panel which has not been set up at this time.

Law

Section 1.501(c)(3)-1(a)(1) of the Regulations states that in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational or operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the Regulations states that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the Regulations states that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(a)(1)-1(c) of the Regulations states that the words "private shareholder or individual" mean an individual having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations states that an organization is not operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. It must not be operated for the benefit of private interests.

Application of Law

As the founder and president of the nonprofit organization, and also as the owner and president of [REDACTED], [REDACTED] has control of both organizations. [REDACTED] donated substantial funds to the organization to buy the property for the purpose of the buying and selling operation. It is clear that [REDACTED]'s relationship with the nonprofit organization goes beyond that of an independent contractor.

[REDACTED]

In International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36, the Tax Court considered the qualification for exemption under section 501(c)(3) of the Code of a nonprofit corporation that conducted continuing medical educational tours. Michael Helin, trustee and executive director of the nonprofit corporation, was also a shareholder and president of H & C Tours, a travel agency. The Foundation used H & C Tours exclusively for all travel arrangements. The Foundation did not solicit competitive bids from any entity other than H & C Tours. In holding the Foundation not to be exempt, the Court stated:

When a for profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3), even if it furthers other exempt purposes.

Revenue Ruling 69-383, 1969-2 C.B. 113 provides a contrast against the above court case. In this revenue ruling, the exempt status of a hospital was considered in the context of its contractual arrangement with a radiologist for his professional services. Facts indicated that the doctor had no control over, or management authority with respect to, the hospital itself. The parties entered into a contract after arm's length negotiations, agreeing that the doctor would be reasonably compensated on the basis of a fixed percentage of income received for his services. On the basis of these facts, the ruling held that the arrangement did not jeopardize the exempt status of the hospital. The ruling provides the following:

Under certain circumstances the use of a method of compensation based upon a percentage of the income of an exempt organization can constitute inurement of net earnings to private individuals. For example, the presence of a percentage compensation agreement will destroy the organization's exemption under section 501(c)(3) of the Code where such agreement transforms the principal activity of the organization into a joint venture between it and a group of physicians (Lorain Avenue Clinic v. Commissioner, 31 T.C. 141 (1958)), or is merely a device for distributing profits to persons in control (Birmingham Business College v. Commissioner, 276 F.2d 476 (1960)).

Revenue Ruling 69-266, 1969-1 C.B. 151 holds that a nonprofit organization formed and controlled by a physician, "hired" to conduct research programs consisting of examining and treating patients who are charged the prevailing fees for services rendered, is not exempt under section 501(c)(3) of the Code. The revenue ruling concludes that the operation of the medical practice does not differ significantly from

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the private practice of medicine. The organization's primary function is to service the private interest of its creator rather than a public interest.

In University Oil Products v. Campbell, 181 F.2d 451, 7th Cir. (1950), an organization of a commercial character that operates for the benefit of its members or founders cannot be exempt even though it pays no dividends and devotes its entire profits to charity.

### Conclusion

The role of an employee or independent contractor must be that of someone contracted to perform specific services pursuant to arm's length bargaining. When the employee/independent contractor is found to be a controlling element in the arrangement, prima facie evidence of inurement exists, and exemption under section 501(c)(3) will be denied.

██████████ is involved in an activity that is a substantial part of your organization. Based on the facts and circumstances and ██████████'s relationship with the for profit and your organization, his interests in both organizations are intermingled. His proprietary interest in ██████████ can no longer be separated from the public interest that your organization must serve, thus precluding you from being operated exclusively for exempt purposes within the meaning of section 1.501(c)(3)-1(d)(1) of the Regulations. The benefits to ██████████, and through ██████████, ██████████, constitute private benefits and inurement in violation of section 1.501(c)(3)-1(c)(2) of the Regulations.

Accordingly, we conclude that you do not qualify for exemption under section 501(c)(3) of the Code.